

REINVESTMENTS BY AIFs

Executive Summary

- Reinvestment is a tool used by AIFs to reuse the same capital more than once for investment without requiring investors/LPs to actually infuse any capital beyond their commitment amount into the AIF.
- AIFs are not permitted to add reinvested amounts in the calculation of “corpus” to inflate it beyond actual commitments.
- Guardrails around reinvestments vary depending on factors such as fund strategy, type of LPs, tenure and size of the fund.
- Legal and governance considerations include adequate risk disclosures and mitigants, clear provisions to provide for appropriate accounting treatment for compliance with regulations, proforma drawdown notices, co-investment considerations.

Background

A recent settlement order passed by the Securities and Exchange Board of India (“**SEBI**”) with respect to a Category II alternative investment fund (“**AIF**”) discusses alleged breach of concentration norms by the said AIF on account of reinvested amounts being made a part of “investable funds”¹ to calculate the concentration limit of 25% of investable funds for investment in a single portfolio company prescribed under the SEBI (Alternative Investment Funds) Regulations, 2012 (“**AIF Regulations**”) for a Category II AIF (which is not a large value fund for accredited investors).²

SEBI, calling this approach as erroneous, stated that for the purpose of determining “investable funds,” the “corpus” must be confined to the total commitments received from investors and preclude any gains or losses generated by the AIF.³ The concentration limits work differently when it comes to Category III AIFs if they choose to compute their limit on the basis of net asset value of the scheme with respect to investments in listed equity.⁴ In that case, gains or losses will be relevant and directly impact the investment limits.

In other words, if an AIF, having a corpus of INR 110 Crore and investable funds of INR 100 Crore, invested the entire INR 100 Crore across different companies and was able to generate a return of INR 120 Crore, while it can invest an amount higher than INR 100 Crore in total by reinvesting all proceeds received by it, it still cannot invest more than INR 25 Crore in a single investee entity.

This article discusses nuances of reinvestment from a commercial, legal and governance perspective.

Purpose of Reinvestment

¹ The term “investable funds” is defined in the AIF Regulations to mean the corpus of the scheme of the Alternative Investment Fund net of expenditure for administration and management of the fund estimated for the tenure of the fund. Regulation 2(1)(p) of the AIF Regulations.

² SEBI Settlement Order in respect of Examination of Violation of Concentration Norms by AIF and Investment Manager, accessible [here](#).

³ *Ibid*.

⁴ Regulation 15(1)(d) of the AIF Regulations.

The practice of reinvestment or recycling of capital involves the fund investing the same amount of money more than once after it has come back to the fund from investments into investee entities. The purpose of recycling is to enhance returns from a fixed capital base and maximise value from the entire capital pool.

Management fees and fund expenses reduce the corpus available for investment. By recycling capital, managers feel they can offset these expenses, ensuring that the fund is effectively able to deploy the full capital and generate returns on it. Although reinvestments do not guarantee increased returns, they improve the odds of generating higher returns by enabling deployment of capital in excess of the original corpus.

Method of Reinvestment

The terms governing reinvestments (including caps, timing and nature of income) differ across funds focusing on different asset classes. Investors typically do not curtail the ability of funds whose strategy involves the fund receiving recurring income (such as debt funds and real assets focused funds) to reinvest freely because it forms a core part of their strategy.

The fund documents typically govern the manner and extent of such reinvestments, which may be done either by (i) reusing the proceeds for reinvestments received from exits at the fund level, without actually remitting the amounts to the investors and recalling or drawing them down again; or (ii) actually remitting such amounts to them and then recalling or drawing them down again. If (i) is chosen as the modus operandi, a deeming fiction is created which gives it the character of (ii) for all accounting purposes.

In either case, a pro-forma drawdown notice should be shared with investors by the manager in case of reinvestments including to allow them to exercise their excuse rights.

Key Terms impacted by Reinvestment

Some of the key principal terms of the fund that generally get impacted on account of reinvestments and should be carefully considered include drawdowns, return of capital, computation of preferred rate of return, management fees, post-commitment period considerations, tax distributions and distribution waterfall.

Risks associated with reinvestments

While recycling capital offers great benefits, an aggressive use of this tool in poorly executed investment strategies could adversely impact the investors.

A significant risk with reinvestments is that an aggressive recycling of capital may cause liquidity concerns for the investors, more specifically for private assets focused funds where underlying investments are typically illiquid. Investors are also concerned that broad flexibility with reinvestments may lead the manager to repeatedly allocate capital to shorter tenure investments, potentially affecting the availability of capital for investments aligned with the fund's primary strategy of patient investing (if relevant). In addition, recycling can present operational challenges in tracking and accounting for recycled amounts. Managers should implement robust fund accounting systems, internal policies, and compliance checks to ensure accurate monitoring and reporting.

Risk Mitigation Strategies

Over time investors have negotiated limits in the fund documents to mitigate the risks associated with reinvestments. These may differ across asset classes and investment strategies. Common industry practices include fund lifecycle related time-limits, limits pertaining to timing of proceeds, type of proceeds, overall cap.

Conclusion

Recycling of capital is an increasingly indispensable tool in the hands of fund managers. It empowers them to seize attractive investment opportunities as they arise, even after the initial capital has been deployed. This is important in a dynamic market where the best opportunities may not always align with the drawdown schedule or investment strategy determined by a manager in advance.

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